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Accentuating Accountability

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ACCENTUATING ACCOUNTABILITY

by

Leonard M. Savoie

before

The Hawaii Society of CPAs

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Princess Kaiulani Hotel
Honolulu

ACCENTUATING ACCOUNTABILITY

When your invitation to this annual meeting came to my desk back in New York, it led me to reflect for a moment on how long, and how romantically, every American in the forty-eight contiguous states has been aware of Hawaii.

As far back as I can remember, songs like "Aloha Oe" and "On the Beach at Waikiki" have been part of the popular music on the mainland. There was a period when the ukulele was as ubiquitous among the young as the guitar has become more recently. One of the best known recording personalities in the days of the hand-wound Victrola was known simply as Ukulele Ike. And there probably wasn't anyone over the age of fifteen, from Bangor, Maine to San Diego, who was not familiar with the undulations of the hula hula.

In short, the cultural impact of this group of islands, despite their relative remoteness in the days before air travel, was far greater than that of many regions of the United States as the country was then comprised.

This is my first visit to Hawaii, and although I've been here for only a few hours, I can understand why this has been so. I am enjoying the experience immensely and am grateful for your having asked me to be with you.

As the theme of my remarks, I have selected <u>accountability</u>. As you all know, various periods of time come to be labeled according to some development that attracts widespread attention and interest. The late Sixties were frequently referred to as the Era of Mergers. Some time earlier, editorialists and commentators spoke often of the Electronic Age, the Computer Age, the Air Age.

In my opinion, it's not unlikely that we are now entering into the Accountability Age. Many signs point in this direction.

The so-called consumer movement, for example, consists largely of a demand that manufacturers be more accountable for the quality of their products and the claims made for them on labels and in advertising.

Parents are asking that educators and school administrators give better accountings than they have been accustomed to do as to the effectiveness of their programs.

People are pressing companies for fuller and more objective reports as to the effects of their operations on the environment.

Since accountability is (in the jargon of today's young people) the "thing" of certified public accountants, an age of accountability obviously affects us more than casually. One result of this fact is that Opinions and drafts of Opinions have recently been emerging from the Accounting Principles Board at a faster rate than ever before. Yet changes in business and financial activities are occurring so rapidly that we are hard pressed to keep pace by formulating appropriate accounting standards.

The APB has a heavy agenda for 1971. Some of the subjects on which action has already been taken or which will receive early attention include the following:

During the past two months the APB has issued two final Opinions -- Number 18 on The Equity Method of Accounting for Investments in Common Stock and Number 19 on Reporting Changes in Financial Position.

The first of these deals with long-term investments in common stock. In this pronouncement the Board extends use of the equity method of accounting (which heretofore was required just for unconsolidated domestic subsidiaries) to all unconsolidated subsidiaries. It also requires use of equity accounting for corporate joint ventures, fifty-percent-owned companies, and investments in voting common stock which give the investor the ability to exercise significant influence over operating and financial policies of the investee.

The opinion stipulates that an investment of 20 percent or more of the voting stock of a company will be considered as indicating ability to exercise significant influence, in the absence of evidence to the contrary.

Conversely, an investment of less than 20 percent of the voting stock will be regarded as showing that no such influence exists, unless it can be demonstrated.

Equity accounting is required under this Opinion not only in consolidated financial statements but in parent-company-only financials issued as primary statements to stockholders.

Opinion 19 requires that a presentation of changes in financial position (funds statement) be included as a basic financial statement whenever a balance sheet and a statement of income and retained earnings are presented. It was the view of the Board that information concerning the financing and investing activities of a business enterprise, and a summary of changes in its financial position, are essential for owners and creditors in making economic decisions.

As you know, presentation of a funds statement has been recommended, though not required, by the accounting profession for a long time. It has been recommended also by the stock exchanges. Quite recently, the SEC declared that a funds statement will henceforth be a required item in registration statements and reports filed with the Commission.

The need for a funds statement as a required, rather than merely optional, item of information was highlighted in the past year or so when a number of companies experienced financial difficulty. At such a time, the attention of knowledgeable investors focuses on liquidity, and they want information that is not easily obtained from the balance sheet or statement of income alone. The statement of changes in financial position contributes materially to answers to such questions and its required presentation should be welcomed by financial statement users. Thus the new Opinion is quite timely.

In addition to these two final pronouncements, the Board in recent months has exposed for comment two draft Opinions.

One would require imputing interest on long-term receivables and payables. It would require that a long-term receivable or payable be discounted at an appropriate rate when it is either non-interest bearing or bears an interest rate clearly below a reasonable rate at the time of a transaction.

Imputing interest looks to the substance of a transaction rather than its form. The application of this method would result in more realistic reporting of the principal amount of the long-term receivable or payable and the related interest income or expense. For example, a company selling land or a building and receiving a non-interest bearing note as part of the proceeds would report a lower profit on the sale than indicated in the stated terms of sale and would report interest income over the life of the note; conversely, the buyer would report interest expense over the life of the note. The exposure period on this draft opinion ended May 1, and it is expected a definitive pronouncement will be agreed upon in July.

You may recall that a draft on changes in accounting methods was originally exposed a year ago last February. Further action was then deferred, however, in order to give the APB time to explore alternative proposals. The Board's reconsideration of this subject led to a second exposure draft this past January.

Under the current proposal, accounting changes would be restricted to situations where it can be demonstrated that the new method will result in more useful financial information than the former method. When a change is made, its effect would be reported in the income statement for the year of change. This adjustment would appear after "income before extraordinary items" and before "net income". Supplementary disclosure of the effect of the change on net income and earnings-per-share for the current period and all prior periods presented would also be required.

Comments on the exposure draft were due by May 15. It is expected that a final opinion will be issued following the Board's June meeting.

The Board's agenda is literally loaded with items approaching the exposure stage. Although time does not permit a full review of each of these, I will briefly discuss a few of the more important subjects.

Discussion of the equity method of accounting led the APB to a separate consideration of accounting for equity securities when significant influence over operating and financial policies does <u>not</u> exist. The Board is re-examining present practice in this area and is considering a proposal that investments in equity securities be measured at current market value, net of income tax effect, in balance sheets.

It is also considering alternative methods of accounting for changes in market value in the statement of income. One method being discussed would require that unrealized gains and losses, net of taxes, be included in income as they occur. Another would recognize both realized and unrealized gains and losses in the income statement on a long-term yield basis. Other proposals would have these gains and losses reported outside the income statement.

Despite the obvious obstacles to market value accounting, I believe there is growing sentiment and authoritative support for its use by all companies in accounting for marketable equity securities. This possibility, of course, concerns the financial community generally, and is of particular interest to insurance companies, brokerage firms and other heavy investors in these securities. Because of this, public hearings on the subject have been scheduled for May 24-25. The hearings will be the first the APB has ever held on an open basis, as contrasted with an invitational basis, and I think the turn-out will be large and participation in the discussions by interested parties will be active.

The Board is studying the question of transfers of assets which do not involve cash. This includes distribution of appreciated non-cash assets from an enterprise to its owners and exchanges of non-cash assets with other than owners. The principal question involved is whether an increase in value of the assets should be accounted for at the time of the transfer.

Another subject the Board is considering is accounting for the purchase and retirement of debt. This is an important problem today because many of the issues being reacquired were convertibles which were selling at a deep discount.

Inasmuch as a convertible security has some elements of equity as well as of debt,the question arose as to whether some portion of the discount should be an addition to capital or whether it is all income. The question is far from decided, but the trend of the Board's thinking seems to favor accounting for the discount as if the security were debt. This would be consistent with an earlier Opinion of the Board which held that no amount of the proceeds should be allocated to the convertible feature of a convertible security at the time it is issued.

Notwithstanding this trend of thinking, study of the problem has led the Board to broaden its consideration to cover purchase and retirement of all debt -- whether convertible or not and whether at a discount or at a premium. Some have questioned whether discount on the purchase and retirement of any debt should be included in income.

More and more annual reports contain a description of the accounting policies adopted in preparing financial statements. Many favorable comments have been made on this kind of disclosure, and the APB is thinking about giving it further impetus by issuing a Statement recommending that companies describe major accounting policies in one place.

The Board has a few items of unfinished business from prior Opinions. Its pronouncements on accounting for income taxes left for further study the application of deferred tax accounting in five special problem areas -- namely, undistributed earnings of subsidiaries, amounts designated as "policyholders' surplus" by stock life insurance companies, "general reserves" of stock savings and loan associations, deposits in statutory reserve funds by United States steamship companies, and intangible development costs in the oil and gas industry. This last area will be considered in a proposed Opinion on accounting problems in the extractive industries, which is beginning to receive active consideration following publication of Accounting Research Study 11.

The other four problems will receive attention in 1971. Current thinking seems to favor tax allocation on deposits in statutory reserve funds by United States steamship companies, because these deposits seem to create timing differences which call for tax allocation under APB Opinion 11. The three other areas seem to result in book-tax differences which are neither timing differences nor permanent differences as defined in Opinion 11. A tentative recommendation would be to provide tax on the differences only to the extent that planned operations can reasonably be expected to result in reversals of the differences, thus causing payment of tax.

The Board has noted that the Administration and the Congress are considering tax incentives of various kinds to achieve social and economic goals, such as encouraging capital spending to stimulate the economy and reduce unemployment, providing job training opportunities for the disadvantaged, and curbing pollution of the environment. The Board plans to study accounting ramifications of these proposals as action on bills becomes imminent, so that appropriate accounting for specific tax incentives will be developed on a timely basis.

Because of the complex and changing nature of American business and the way in which accounting principles are applied in practice, the APB must constantly review the applicability and effectiveness of previous pronouncements. One such matter relates to accounting for leases. An earlier Opinion noted an apparent inconsistency between accounting methods recommended for lessors and lessees. In reconsidering this problem, the Board is reviewing some basic problems of both lessors and lessees.

Opinion 7 described the operating and financing methods of accounting for lease revenues by lessors and described conditions under which each method is appropriate. That Opinion also specified that a manufacturer could record a manufacturing profit upon entering into a financing lease, provided certain conditions were met. Practice under this Opinion has raised questions as to the adequacy of criteria for this purpose. Some lessors have recorded manufacturing profit upon entering into a lease for as short a period as one year. The Board intends to tighten up in this area.

As to lessees, the Board has tentatively agreed that leases which are financing leases should be capitalized. Study is being given as to whether still more leases should be capitalized. Also under study is appropriate income statement treatment of capitalized leases. A typical lease with equal annual payments ordinarily would result in rent expense of the same equal annual amounts. Questions are being raised as to whether the combination of depreciation and interest expense that would arise through capitalization should also be made to result in equal annual amounts. Purchase of the same asset would ordinarily result in depreciation in equal annual amounts and interest expense in declining amounts, thus resulting in a combined expense that is high in earlier years of use of the asset and declining throughout the life.

The Board has taken note of the proliferation of new types of stock option and other stock compensation plans, including tandem and phantom plans, and it intends to develop guidelines for recognizing the compensation expense involved.

In 1970 a huge number of extraordinary items appeared in corporate income statements, thus leading the Board to reconsider whether more specific criteria than those provided in Opinion 9 are needed for identifying an extraordinary item.

Opinion 15 created the concept of a common stock equivalent for use in computing primary earnings per share. Yet the Opinion stated that the concept should not be introduced into the financial statements and particularly not into net income. This is a conceptual inconsistency that has been highlighted by issuance of Opinion 18 on equity accounting. The Board will consider reconciling this difference.

A Statement issued by the APB in 1967 encouraged disclosure of information by line of business when a company operates in more than one industry. Many companies have since been reporting information by line of business in annual reports, and recently such disclosures have been required in filings with the SEC. For the most part, these presentations have not been subject to independent audit.

The APB, however, has on its agenda the development of an Opinion which would make disclosure of such information a requirement and provide standards for presenting it.

Often auditors are called upon to report on financial statements of a subsidiary company, a division or a branch of a corporation. As guidelines for reporting on a component of a business are inadequate, the APB is studying the subject with the intent of issuing an Opinion.

Quarterly financial statements are becoming more common. Stock exchanges require them and now the SEC is doing so, too. Therefore the APB is working on an Opinion which would set standards for interim period reporting.

Last year the Institute's Accounting Research Division published a research study on Accounting for Extractive Industries. Now that comments on the study have been received from interested parties, the subject has been moved up on the APB's agenda.

Many other projects are in the research stage, including intercorporate investments, stockholders' equity, foreign investments, depreciation, inventory valuation and industrial research and development. As each study is completed, the subject then comes to the APB for consideration of an Opinion.

The Institute's program for improving accounting principles also includes a series of audit guides for specific industries. These guides are prepared by committees of

Institute members who are specialists in the particular industry, thus expanding the capability of the Institute for setting standards beyond that represented on the APB. To assure consistency of accounting principles, however, an audit guide is released only after being reviewed by the chairman of the APB for overall conformity with the more pervasive pronouncements of the APB. Audit guides, like APB Opinions, are exposed in draft form for comment prior to final issuance.

The Institute has exposed a draft of an audit guide for life insurance companies. The industry is subject to regulations which have been designed primarily to assure protection of policyholders, and, while this is commendable, the regulatory form of financial reports is not necessarily a fair presentation for investors.

Insurance regulatory requirements are such that a vigorous company which is acquiring new business could be reporting meager income or possibly a loss. At the same time, a company which is suffering a decline in volume of business may be showing high profits. This is a paradoxical situation which calls for attention, particularly since insurance companies are increasingly turning to CPA firms to add credibility to their financial statements.

To correct the deficiencies in reporting to insurance company investors, an American Institute committee is working with insurance industry associations to develop improved rules for matching costs with revenues. Good progress has been made, and new rules could be in force by the end of the year.

Many financial analysts now make adjustments to reports of publicly-held stock life insurance companies for greater comparability with reports of other industries. This would no longer be necessary under the uniform guidelines proposed.

Much of the draft is concerned with how the liability for policyholder benefits should be determined. It endorses the so-called "natural reserve" method. Under this method, more realistic assumptions would be made as to acquisition costs, future interest rates, assumed mortality rates, withdrawals and policyholder dividends. Also, costs of acquiring new business would be spread over the periods in which income is recognized. Present practice is to write off these expenses as incurred.

The Institute's committee on insurance accounting and auditing, after considering comments which were due by May 15, is expected to publish the guidelines in final form. I have already mentioned that the Accounting Principles Board is considering provisions for deferred taxes on policyholders' surplus in a stock company and the manner in which gains and losses on investments in marketable equity securities should be recognized. It is expected that the final guide will contain recommendations on these matters, as well as specify the extent to which the guide will apply to mutual companies.

Audit guides are also well along toward completion for stock brokerage firms, savings and loan associations, and hospitals. Guides are being prepared for health and welfare funds, governmental accounting, finance companies, colleges and universities, defense contracts, pension funds, fire and casualty insurance companies, land development companies and investment companies.

A mere listing of all these efforts is sufficient to indicate the seriousness of the profession's resolve to improve financial reporting standards, and in view of the importance of APB Opinions and Institute audit guides to industry and the investing public, the Institute has just formed two high-level study groups to consider whether these efforts are sufficiently prompt and productive. One group will study whether present procedures for establishing accounting principles can be improved; and the other will seek to refine the objectives of financial statements. Both groups will consult with interested organizations and individuals, hold hearings and maintain a public record.

Each group includes representatives of business and professional life outside public accounting. In fact, a majority of those on each study group is from outside public practice. The group studying the establishment of accounting principles is chaired by Francis M. Wheat, a recent member of the Securities and Exchange Commission. Serving with him are a university professor, a financial analyst, a financial vice president of one of the nation's largest industrial corporations, and three CPAs engaged in public accounting practice.

The group studying the objectives of financial statements is chaired by Robert M. Trueblood, a practicing CPA and past president of the American Institute. Serving with him are a financial analyst, an economist, an industrial executive, two professors, and two CPAs from public practice.

The study on establishment of accounting principles is expected to be completed within 6 months and the study on objectives within 18 months.

I hope these remarks have demonstrated the concern of the Institute for seeing that the public is served by the highest attainable standards of financial reporting. The Institute expects to continue to provide leadership and assume responsibility for this function. But we cannot reach this goal without cooperation of the business and financial community. If we have this cooperation, I don't see how we can fail to give the public the reliable information it deserves.

So far I have talked only about accounting issues which are presently before the Accounting Principles Board for deliberation and decision. These are pressing issues affecting business which the profession is expected to deal with promptly.

But in the age of accountability, there are many broader issues which should be considered by the accounting profession if we wish to take advantage of the current emphasis being placed on accountability. Needs for accountability are arising in both the private and public sectors which are well beyond the traditional services provided by public accounting -- including audited interim financial statements, assurance as to adequacy of internal controls, audits of forecasts and budgets, compliance with federal programs, management audits, program performance reviews and social accounting. Exciting opportunities exist if the profession takes the initiative in setting standards which provide professional guidelines for performing these services.

Although the accounting profession is expected to provide leadership in accountability, the public cannot be expected to wait for us to get around to these broad needs for accountability. For other disciplines may well supply the needed services if we are dilatory in responding.

Time does not permit a further discussion of this subject, but I would not feel comfortable in talking about "Accentuating Accountability" without at least calling your serious attention to broader professional opportunities.

I am convinced that the accounting profession can and will devote the resources necessary for it to become a dominant force in the Accountability Age.

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